No.

Office-Supreme Court, U.S.
FILED
JUN 19 1981
ALEXANDER L. STEVAS,

80-2154

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ZENITH RADIO CORPORATION, et al.,
Petitioners,

v.

ROBERT EDWARD MCGRATH,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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June 19, 1981

Pandick Press Midwest, Inc. Chicago • 454-7600

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Pursuant to Supreme Court Rule 19, petitioners[1] pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on January 28, 1981, as modified by its order dated May 20, 1981.

QUESTIONS PRESENTED

1. Whether representations made to one of a group of selling employee-shareholders about future employment prospects can be deemed to have occurred in connection with a sale of securities when:

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[1] Petitioners, the named defendants in this action, are Zenith Radio Corporation, Zenith Distributing Corporation of Northern California, Walter C. Fisher and Amile J. Forni.

(a) the price of the stock sold is stipulated to be fair and to have been negotiated in an arm's-length transaction prior to the representations;

(b) contingent rights to buy additional shares of stock in the future were waived by one of the selling shareholders;

(c) no alleged deception occurred affecting the group of selling shareholders or pertaining to the value of the company being sold, its stock, or the one shareholder's contingent rights; and

(d) the economic realities of the transaction involved no investment decision by respondent, but rather involved the sale of an entire business by one management group to another.

2. Whether the practice of pleading spurious federal securities law claims, later disavowed during the trial and obviously asserted for the purpose of obtaining a federal forum to determine state law claims, should be countenanced by this Court.

3. Whether the majority below, admittedly not knowing whether the jury's general verdict was based on a state law fraud theory of liability, or on federal securities laws or state law contract theories that the court ruled could not sustain the judgment, properly denied a new trial on the ground that to triumph on appeal, petitioners must show that under none of the three rationales was respondent entitled to the award of compensatory and punitive damages.

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OPINIONS BELOW

The majority and dissenting opinions of the Court of Appeals are set forth in Appendix A hereto. The order of the Court of Appeals denying the petition for a rehearing *en banc* and modifying the majority opinion is set forth in Appendix B hereto. The order of the district court is set forth in Appendix C hereto. No opinion was rendered by the district court.

JURISDICTION

The judgment and opinion of the Court of Appeals for the Seventh Circuit, Judge Swygert dissenting, was originally entered on January 28, 1981. Petition for rehearing and suggestions for rehearing *en banc* were filed on February 11, 1981. The court below, on consideration of the petition, modified its

judgment and opinion by order dated May 20, 1981. The court denied the petition and suggestions in all other respects, Judge Swygert voting to grant rehearing and rehearing *en banc*. This Court's jurisdiction is invoked under 28 U. S. C. § 1254(1) and Rule 19 of this Court.

STATUTES AND RULE INVOLVED

This case involves section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b); 28 U. S. C. § 1331; and Rule 10b-5 of the Securities and Exchange Commission, 17 C. F. R. 240.10b-5, the texts of which are set forth in pertinent part in Appendix D.

STATEMENT OF THE CASE

Respondent Robert Edward McGrath originally filed this action in July, 1975 as an alleged diversity of citizenship case. McGrath's two-count complaint claimed common law fraud and tortious interference with his employment in connection with Zenith's purchase of the business of H. R. Basford Company. (R. C. Item 1.) Petitioners in their answer denied subject matter jurisdiction because McGrath, as a permanent resident of Canada, could not invoke 28 U. S. C. § 1332 (R. C. Item 6 p. 1.)

Seven months later, in response to petitioners' denial of jurisdiction, McGrath attempted to resolve his jurisdictional predicament by filing an amended complaint that alleged federal question jurisdiction. (R. C. Item 16.) In order to give apparent substance to this jurisdictional averment, he alleged one purported Rule 10b-5 count, seeking damages for "receipt of inadequate consideration for his 2,885 shares of Basford Co. stock," an allegation that his counsel admitted to be false at trial. (A. 98.) He also alleged seven separate state law counts based on a variety of tort and contract theories of liability.

McGrath had been Basford's general manager when Zenith purchased the Basford business in 1972. Basford was organized as a California corporation and conducted a local business distributing Zenith products and certain other consumer merchandise in the San Francisco area. Under the terms of a stock ownership agreement, Basford shares could only be owned by active employees of the business. Upon termination of employment for whatever reason, an employee was required to resell his shares to the company or to another active employee at a price equal to 95% of book value. (Pl. Ex. T. ¶ 5, R. 352.)

McGrath joined Basford as general manager in August, 1971, only about six months before Zenith and Basford began negotiations for purchase and sale of the assets and business of the Basford company. (R. 99.) He was a Harvard business school graduate with one year of law school training and some prior experience with another distributor in the San Francisco area. (R. 229-295, Pl. Ex. E.) He was hired at a salary of $35,000 annually (R. 300), and as part of his compensation package received a conditional agreement under which he could have purchased an additional 5,115 shares of Basford stock. (Pl. Ex. B.) However, stock could be purchased under McGrath's conditional agreement only after three years of employment and only in the event the California Commissioner of Corporations approved the issuance of additional shares. (Pl. Ex. B.) By the time Zenith purchased the Basford business McGrath had acquired 2,885 shares outside of the agreement, or about 3% of the 103,845 shares outstanding, for approximately $66,290. (Pl. Ex. T. ¶ 9.)

In February, 1972 Basford and Zenith began discussing the possibility of Basford expanding its distribution of Zenith products into the Sacramento market. Because of Basford's limited capital, the parties agreed that the expansion could be best handled if Zenith purchased and operated the Basford business. (R. 114-118, 124-126, 161-162, Pl. Ex. T. ¶ 10.)

McGrath was Basford's principal spokesman in these merger negotiations. (R. 339.) On June 2, after several months of bargaining, McGrath and Forni, Basford's president, accepted Zenith's offer to purchase the Basford business for a price of $3,946,110 or $38 per share, subject to the approval and acceptance of this offer by McGrath's fellow employee-shareholders. (R. 159-163, 350-353, Pl. Ex. T. ¶ 15.)

Following the June 2 meeting, the parties drafted a purchase agreement which structured the transaction as a stock acquisition. The agreement recited that Zenith "desires to acquire all of the assets and business of [Basford] (except the trade name and goodwill)" and that "the desires of all of the parties can best be met by a purchase by [Zenith] of all of said shares of Common Stock of [Basford] outstanding as a first step in [Zenith's] plans to develop and expand [Basford's] business." (Def. Ex. R.) After drafting was completed, it was decided that the agreement would be presented to the Basford employee-shareholders on July 12, 1972. (R. 172-173.)

On July 13, the day after the shareholder's meeting, a complication arose when McGrath for the first time told Zenith's representative, Fisher, that he felt that he was entitled to something more than his fellow shareholders because he was waiving his conditional stock right to facilitate the sale. McGrath testified at trial that he told Fisher that, because of his conditional right to purchase additional shares, he felt he "gave up more than anyone else in this company by the sale" and that he "would like to have a three-year employment contract with the H. R. Basford Co. under your ownership." (R. 178.)

McGrath testified that in response to his request, Fisher said "it was not the practice of Zenith Radio Corporation to have employment contracts with any of their executives, including himself . . . and it would have to be that there would be no contract" but that "I was the heir apparent and I was to benefit from the programs he had outlined." (R. 178.) He further testified that, in reliance on Fisher's statements, he

agreed to waive his conditional stock right, which was not effective for another two years, providing all employee-shareholders approved the sale. (R. 178-179, Pl. Ex. H.)

Later the same day, Fisher met with Forni and learned for the first time that Forni had reservations about McGrath's suitability as a future president for the new subsidiary. (R. 957.) Fisher asked Forni to wait three or four months "to see if you can't work this out" but did not tell McGrath about this conversation. (R. 958-959.)

On July 14, 1972 McGrath, Forni and all other Basford employee-shareholders signed the stock purchase agreement, and McGrath received $107,730 for his 2,885 shares that he had purchased for $66,290. (Pl. Ex. T. ¶¶ 9, 16.) This gave him a 62% profit of more than $40,000 on stock that he had held for less than a year.

McGrath continued as general manager under Forni in the successor Zenith Distributing, but after about four months his employment was terminated effective January 1, 1973, with pay to continue through March, 1973. (R. 809, Pl. Ex. T. ¶18.) In April, 1973, with Zenith's assistance, McGrath found a new position as sales manager for Fleetwood Corporation of Canada. (R. 376.) His new position paid $42,000 per year or about $7,000 more annually than he had earned with Basford. (R. 464, Pl. Ex. A, G, N, Def. Ex. J.)

McGrath filed his original diversity complaint on July 11, 1975. The complaint contained absolutely no allegation of wrongdoing whatsoever in connection with Zenith's purchase of Basford shares from McGrath or his fellow shareholders. The complaint only alleged that "representations were made [concerning future employment] with the intent and purpose of inducing Robert Edward McGrath to waive his stock option right to acquire additional stock in H. R. Basford Company." (R. C. Item 1.)

After petitioners challenged McGrath's diversity allegation, he filed an amended complaint, which for the first time alleged that the district court "has federal subject matter jurisdiction over this suit pursuant to 28 U. S. C. § 1331(a) in that Count VIII herein seeks recovery for the violation of the federal securities laws." (A. 36.) Count VIII of the amended complaint alleged for the first time that McGrath's claim involved the sale of his Basford shares and that as a result of Zenith's false promises concerning his future "career opportunity," McGrath received "inadequate consideration for his 2,885 shares of Basford Co. stock." (A. 98.) By means of this bare allegation McGrath was able to avoid petitioners' repeated challenges to federal jurisdiction in their answer (A. 60) and motion for directed verdicts at the close of respondent's case. (R. 677-704.) It was only after McGrath had rested his case at trial that he finally stipulated voluntarily that he was paid a fair price for his Basford shares:

> Your Honor, there is *no controversy* about the price of the stock that was reached. It was an *arm's length transaction,* and as far as we are concerned, the $38 per share paid at the time *was fair* . . . for the record we are stipulating that $38 per share, the negotiated price, was a *fair price* per share. (R. 1062, emphasis added.)

Finally, McGrath admitted that his entire case turned not on his sale of Basford shares, but only on waiver of his conditional stock right, as he had alleged in his original complaint. When he conceded the fairness of the stock sale, McGrath was left with a case involving only his waiver of a conditional stock purchase opportunity in the expectation of continued employment and future promotions. (R. 178.) He had already admitted that, in his opinion, his conditional right would at most have been worth $65,000. (R. 381-383.)

Despite the evident deficiencies in McGrath's federal securities law case, the district court denied petitioners' motions for directed verdicts at the close of respondent's case and at the

close of all the evidence. In closing argument, McGrath's counsel, over objection, exhorted the jury with emotional appeals about how defendants "have literally driven him out of the country" and "chas[ed] the man out of his country" to find employment in Canada. (R. 1248, 1251.) The jury, not unnaturally, responded to this appeal by returning a general verdict awarding McGrath one million dollars compensatory damages and one million dollars punitive damages for his claimed loss of a "career opportunity" with Zenith. This was ten times the amount McGrath claimed in his amended complaint. (A. 57.) The district court entered judgment on the verdict and subsequently denied petitioners' post trial motion without opinion or explanation of any kind. (A. 529.)

On appeal, the court below split two to one on the issues raised by this petition. The majority held that McGrath's federal securities law claim was not so "obviously frivolous," "obviously without merit" or "essentially fictitious" that this Court's decisions left "no room for the inference that the questions sought to be raised can be the subject of controversy." (Appendix A. p. 6a.) The majority did not reach petitioners' contention that any claim based on McGrath's waiver of his conditional right was barred by *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U. S. 723, 95 S. Ct. 1917 (1975). The court held that McGrath's 10(b) claim was "based upon the sale of his Basford shares, as well as on the waiver of his option." (Appendix A. p. 14a.) To reach this result after McGrath had abandoned his claim of inadequate consideration, the majority below applied the so-called "touch test" for determining federal securities liability. Under this test, the court held that Fisher's July 13 oral statements were material to McGrath's decision to complete the stock sale and were "surely close enough" to "touch" that transaction. (Appendix A. p. 13a.) The majority cited no specific standard supporting its conclusion.

In affirming the judgment on the verdict, the majority held that "to triumph on appeal [petitioners] must show that under

none of the three rationales was [respondent] entitled to the award of compensatory and punitive damages." (Appendix A p. 7a.) Although affirming the $1 million punitive award, the majority reduced the compensatory damages to $300,000, giving respondent the opportunity to refuse the remittitur and submit to a new trial on damages.

Judge Swygert disagreed with every aspect of the majority's decision. He denied that the jury's verdict could be sustained on any state law contract or fraud theory of liability, and with respect to McGrath's federal securities law claim, declared that the alleged representations by Fisher were completely unrelated to McGrath's sale of shares:

> That price was agreed upon before the alleged misrepresentations were made, and it was stipulated at trial that the price was fair. No present employment opportunities or promises of future employment entered into the considerations given to fixing the price per share. (Appendix A. p. 27a.)

In response to the majority's statement that if McGrath had been told of Fisher's conversation with Forni, he might have blocked Zenith's purchase by refusing to sell his shares or to waive his conditional right, Judge Swygert pointed out:

> McGrath, however, could not have effectively blocked the sale or kept his opportunity to buy. His right to keep his shares and his opportunity to buy more shares was contingent on his continued employment. He could have been fired at any time. Under the terms of his contract, his right to buy more shares would have been extinguished, and he could have been forced to sell his acquired shares to the employee stock trust at less than book value. (Appendix A. p. 28a.)

Judge Swygert noted that the statement about McGrath being "heir apparent" to Forni was nothing more than speculation. (Appendix A. p. 26a.) In addition to finding no basis what-

soever for any liability, Judge Swygert said of the punitive damage awards "[t]o award him one million dollars in punitive damages in these circumstances is to work a grave injustice instead of rectifying one." (Appendix A. p. 29a.)

REASONS FOR GRANTING THE WRIT

1. THE DECISION BELOW IMPROPERLY ADOPTS A FEDERAL GENERAL FRAUD REMEDY UNDER THE GUISE OF SECTION 10(b) WITHOUT THE BENEFIT OF CONGRESSIONAL APPROVAL AND IN CONTRAVENTION OF THIS COURT'S DECISIONS

The Court of Appeals, relying solely on respondent's sale of Basford stock, concluded that alleged misrepresentations concerning his personal future employment prospects made after the completion of arm's length negotiations resulting in an admittedly fair sales price occurred in connection with the sale of the stock. In reaching this unprecedented decision, the majority below has improperly transformed section 10(b) and Rule 10b-5 into a federal general fraud statute, thus directly or implicitly contradicting all of this Court's recent decisions restricting the scope of that statute and rule within the bounds of its original congressional purpose.[2]

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[2] Since 1975, this Court has exercised its certiorari jurisdiction in nine cases involving Rule 10b-5, each time limiting the availability or exercise of a federal remedy. *Chiarella* v. *U. S.*, 445 U. S. 222, 100 S. Ct. 1108 (1980); *International Brotherhood of Teamsters, etc.* v. *Daniel*, 439 U. S. 551, 99 S. Ct. 790 (1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462, 97 S. Ct. 1292 (1977); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U. S. 1, 97 S. Ct. 926 (1977); *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438, 96 S. Ct. 2126 (1976); *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185, 96 S. Ct. 1375 (1976); *United Housing Foundation, Inc.* v. *Forman*, 421 U. S. 837, 95 S. Ct. 2051 (1975); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 95 S. Ct. 1917 (1975); *Rondeau* v. *Mosinee Paper Corp.*, 422 U. S. 49, 95 S. Ct. 2069 (1975).

This case, like *Santa Fe Industries, Inc.* v. *Green,* 430 U. S. 462, 97 S. Ct. 1292 (1977), contains no claim of any "omission, misstatement or fraudulent course of conduct that would have impeded a shareholder's judgment of the value of the offer" for McGrath's Basford shares. 430 U. S. at 469, 97 S. Ct. at 1298, quoting the district court's findings, 391 F. Supp. 849, 854 (S. D. N. Y. 1975). Because this respondent claims no deception regarding any fact material to his valuation of the stock, the finding of a securities fraud violation results in the creation of a federal remedy to redress alleged breaches of contract and fiduciary duties, neither of which relate to any selling shareholder other than McGrath. These claims are matters more appropriately governed by state common law principles.

Such a general and unrestricted expansion of federal jurisdiction should result from a congressional, not judicial, initiative. *Texas Industries, Inc.* v. *Radcliff Materials, Inc.,* ____ U. S. ____, 49 U. S. L. W. 4537, 4540-41 (May 26, 1981) and cases cited therein. The wording of section 10(b) and its legislative history disclose only the congressional intent to ban manipulative and deceptive devices occurring in connection with the purchase or sale of a security. Petitioners submit that, in this instance, the most that respondent has ever alleged is deception about his personal future employment prospects occurring contemporaneously with the purchase or sale of a security. If, as this Court has ruled, section 10(b) is not to be read as a federal general fraud statute, the "in connection with" limitation of the statute must require a greater logical relationship between a fraudulent act and a securities transaction than the fortuitous occurrence of both at or about the same time. See *Santa Fe,* supra, 430 U. S. at 480 n. 17, 97 S. Ct. at 1304. The Seventh Circuit has erred in requiring no stronger connection.

A. No Deception or Manipulation Occurred "In Connection With" McGrath's Sale of Basford Shares.

The Court below cited this Court's opinion in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.,* 404 U. S. 6,

92 S. Ct. 165 (1971), for the proposition that "[s]ection 10(b) must be read flexibly, not technically and restrictively." *Id.* at 12, 92 S. Ct. at 169. Petitioners question only the breadth and not the truth of that proposition. Subsequent decisions of this Court clearly restrict the bounds of acceptable judicial flexibility to the language of and the congressional purpose behind the statute. *Aaron* v. *Securities and Exchange Comm.*, 446 U. S. 680, 100 S. Ct. 1945, 1955 (1980) and cases cited therein.

Because the statute is limited to purchases and sales of securities, standards of materiality and causation tailored to section 10(b) must be applied to determine what facts are required to be disclosed. Facts pertaining to breaches of contract and common law duty, but not to the value of the securities sold, must be deemed to be beyond Rule 10b-5's disclosure mandate if that Rule is to be applied in a predictable manner. The judicial flexibility applied by the Seventh Circuit in this instance exceeds any reasonable statutory construction and adds a whole new and uncharted dimension to Rule 10b-5, contrary to this Court's careful delineation of that Rule.

Although this Court has not to date expressly so stated, petitioners contend that the purpose of the 1934 Act disclosure requirements and § 10(b) in particular is to enable a purchaser or seller of securities properly to appraise their value from full disclosure of facts which are material to that determination. See *Schoenbaum* v. *Firstbrook*, 405 F. 2d 200, 212 (2d Cir. 1968), rev'd *en banc* on other grounds, 405 F. 2d 215, cert. denied, 395 U. S. 906, 89 S. Ct. 1747 (1969). Congress has chosen to use this same "market approach" to investor protection in the related area of tender offers. *Great Western United Corp.* v. *Kidwell*, 577 F. 2d 1256 (5th Cir. 1978), rev'd on other grounds *sub nom.*, *Leroy* v. *Great Western United Corp.*, 443 U. S. 173, 99 S. Ct. 2710 (1979). As the Fifth Circuit noted in *Kidwell*, 577 F. 2d at 1276-77, "[t]he function of federal regulation is to get information to the investor . . . and then to let the investor decide for himself."

In 1934, both the House and Senate Committees reporting on the Securities Exchange Act noted that full disclosure of material facts pertaining to the purchases and sales of securities was necessary to enable investors to value the securities subject to sale. Report No. 1383 of the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. (1934) ["House Report"]; Report No. 1455 of the Senate Committee on Banking and Currency, 73d Cong. 2d Sess. (1934) ["Senate Report"][3]. The House Report stated the following concern:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. (Ellenberger, Item 18 at 11.)

Similarly, the Senate Report noted the following purpose of the statute:

> The purpose of the act is identical with that of every honest broker, dealer, and corporate executive in the country, viz., to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control. The act strikes

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[3] The House Report appears in Ellenberger and Mahar, *Legislative History of The Securities Act of 1933 and Securities Exchange Act of 1934* (1973) ["Ellenberger"] as Item 18. The Senate Report appears as Item 21.

> deeply not only at defects in the machinery of the exchanges but at causes of disastrous speculation in the past. It seeks to eradicate fundamental and far-reaching abuses which contain within themselves the virus for destroying the securities exchanges. (Footnotes omitted. Ellenberger, Item 21 at 81.)

Nothing in the language of section 10(b) or the legislative history of the 1934 Act indicates that Congress intended to pass a federal general fraud statute. In fact, nothing in the statute or its history indicates that Congress intended to mandate a duty to disclose anything more than all facts affecting the value of a security being purchased or sold. As this Court has noted, the scope of Rule 10b-5 is necessarily limited to the scope of section 10(b). *Santa Fe,* supra, 430 U. S. at 471, 97 S. Ct. at 1300; *Ernst & Ernst* v. *Hochfelder,* 425 U. S. 185, 212-214, 96 S. Ct. 1375, 1390-91 (1976).

Moreover, Courts of Appeals in other circuits have found that the full disclosure required by section 10(b) concerns facts affecting the value of a security. *Broad* v. *Rockwell Intern. Corp.,* 614 F. 2d 418, 437-38 (5th Cir. 1980), mod. *en banc,* 642 F. 2d 929, 963 (1981); *Rochelle* v. *Marine Midland Grace Trust Co. of N.Y.,* 535 F. 2d 523, 529 (9th Cir. 1976); *Arber* v. *Essex Wire Corp.,* 490 F. 2d 414, 418 (6th Cir.), cert. denied, 419 U. S. 830, 95 S. Ct. 53 (1974); *Securities and Exchange Comm.* v. *Texas Gulf Sulphur Co.,* 401 F. 2d 833, 849 (2d Cir. 1968), cert. denied, 394 U. S. 976, 89 S. Ct. 1454 (1969). See also, Section 2(3) of the 1934 Act, 15 U. S. C. § 78b(3); Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627, 657 (1963). Although some lower court decisions admittedly contain dicta indicating that the Rule has a broader scope, these cases all involve some deception relating to either the value of the securities sold or the value of the consideration received. See, e.g., *Herpich* v. *Wallace,* 430 F. 2d 792, 801 (5th Cir. 1970); *A. T. Brod & Co.* v. *Perlow,* 375 F. 2d 393, 395 (2d Cir. 1967); *Hooper* v. *Mountain States Secur. Corp.,* 282 F. 2d 195, 204

(5th Cir. 1960), cert. denied, 365 U. S. 814, 81 S. Ct. 695 (1961).

The majority below relied upon the so-called "touch test" first enunciated in *Bankers Life,* supra, and applied in *Smallwood* v. *Pearl Brewing Co.,* 489 F. 2d 579, 594-95 (5th Cir.), cert. denied, 419 U. S. 873, 95 S. Ct. 134 (1974), to find the claimed deception of McGrath about his personal future employment prospects to be in connection with the sale of the Basford stock. Petitioners submit, however, that because of the complete absence in this case of any alleged deception concerning the value of the securities sold or the value of the consideration received, or affecting the selling Basford shareholders other than McGrath, the Seventh Circuit has in this instance extended the reach of Rule 10b-5 beyond even the outer limits of the "touch test" as applied by the *Bankers Life* and *Smallwood* courts.

The courts in both *Bankers Life* and *Smallwood* found the existence of a "single fraudulent scheme" containing both elements of deception pertaining to the value of securities and a purchase or sale. See 404 U. S. at 12-13, 92 S. Ct. at 169. In *Bankers Life,* the seller of bonds was deceived into believing that it would receive the proceeds of the sale, when in fact it received nothing. 404 U. S. at 9, 92 S. Ct. at 167. See also, *Santa Fe,* supra, 430 U. S. at 475 n. 15, 97 S. Ct. at 1301. In *Smallwood,* the court found deception regarding the availability of certain merger terms beneficial to the plaintiffs to be "tied to the merger transaction sufficiently tightly to pass the 'touch' test of *Bankers Life.*" 489 F. 2d at 595.

No single fraudulent scheme involving both deception about securities and a purchase or sale is present in this case. McGrath's own proof showed that the sale price of $38 per share was negotiated and agreed upon by McGrath at a meeting held six weeks before his July 13 conversation with Fisher, and that $38 per share was a fair price for his and the other shareholders' Basford stock. Because the price was fair,

and was agreed upon *before* McGrath claims he was told he was the "heir apparent," any promises allegedly made to him about future employment could not have affected his valuation of the shares or have constituted additional consideration for the sale. Moreover, as Judge Swygert observed in dissent below, McGrath's claim that representations about his future employment occurred in connection with the sale of the Basford shares, if true, would have resulted in his receipt of an unfair preference over the other Basford shareholders[4].

The majority below, however, did not rely on any deception regarding the value of the Basford shares in finding a violation of Rule 10b-5. Instead, they seized upon this Court's proxy materiality standard. See *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438, 96 S. Ct. 2126 (1976). In doing so, they held that Fisher's statements to McGrath about being "heir apparent" could have been material to McGrath's decision to sell the stock, even if they were not material to its valuation,[5] (Appendix A. p. 12a):

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[4] If this decision is permitted to stand, it establishes a precedent enabling a selling shareholder secretly to negotiate special benefits for himself, through an oral understanding with no disclosure thereof whatsoever to his fellow shareholders, and to obtain the assistance of the federal courts in collecting the illicit gains which he thinks he has been promised. In this case, the undisclosed special benefits were found to be worth $300,000, or about 7% of the sales price of Basford. It would be a gross perversion of the anti-fraud provisions of section 10(b) were they to become the device by which an insider may perpetrate a fraud upon his fellow selling shareholders which they may never discover.

[5] Additionally, the majority assumed that McGrath's assent to the merger was somehow necessary:

> McGrath was free to refuse to sell his shares or to abort the entire transaction by refusing to waive his option.

This assumption, however, is simply incorrect. As the dissent observed, McGrath's stock could have been acquired from him over his objection simply by terminating his employment. At the same

Continued on following page

> The issue presented to the jury was whether a reasonable investor would have considered such utterances important in deciding whether to sell his or her securities. It cannot be said as a matter of law that these statements carried no weight in the seller's decision-making process.

By literally applying the definition of materiality adopted by this Court in relation to the proxy rules without concern for the purpose of section 10(b), the Seventh Circuit has required disclosure of facts completely unrelated to those necessary to assure that securities prices are set by an open and informed market and reflect the value of the issuing company. Such a disclosure standard is improper because it goes far beyond both the wording of and the congressional intent behind the statute.

In *TSC Industries,* this Court recognized that section 14(a) of the 1934 Act "was intended to promote 'free exercise of the voting rights of stockholders' by ensuring that proxies would be solicited with 'explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.' " 426 U. S. at 444, 96 S. Ct. at 2130. The question of materiality was determined by comparing the alleged non-disclosures to the purpose of section 14(a). Recognizing the "broad remedial purpose" of that section, the Court adopted the following materiality standard, 426 U. S. at 449, 96 S. Ct. at 2132:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

Continued from preceding page

time, his contingent rights to purchase additional shares would have been extinguished automatically without any payment being due. Such a transaction, assuming the same factual information remained available about the value of the stock, would involve neither deception nor manipulation and, therefore, could not constitute fraud cognizable under Rule 10b-5. *Santa Fe,* supra, 430 U. S. at 479, 97 S. Ct. at 1304. See also *Ketchum* v. *Green,* 557 F. 2d 1022 (3d Cir. 1977), cert. denied, 434 U. S. 940, 98 S. Ct. 431 (1978); *Robinson* v. *Cupples Container Co.,* 513 F. 2d 1274 (9th Cir. 1975).

Although the *TSC Industries* proxy materiality standard has been applied to other Rule 10b-5 situations, see *Dower* v. *Mosser Industries*, CCH Fed. Sec. L. Rep. ¶ 97,980 (3rd Cir. May 5, 1981), its literal application in this case, without concern for the reasons why factual disclosure is required, results in an uncontrollable extension of the federal remedy into the arena of general fraud. Under the standard set by the majority below, any plaintiff claiming breach of contract, fraud or breach of fiduciary duties, even if completely unrelated to the value of stock purchased or sold, can successfully argue that a reasonable shareholder in his position would likely consider the contract, employment or fraud issues important in deciding whether or not to sell, even if, as in this case, the sale has already been agreed to at an admittedly fair price. That argument will always succeed because the plaintiff will claim that his refusal to purchase or sell the stock affects his bargaining position with respect to the common law issues, a factor erroneously considered important by the majority below. See n. 5, supra.

Other courts have prevented such an improper expansion of Rule 10b-5 into wholly common law areas by requiring proof of causation, a crucial element of an implied right of action under Rule 10b-5 which was ignored by the court below. *Huddleston* v. *Herman & MacLean*, 640 F. 2d 534, 549 (5th Cir. 1981) ("The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value."); *Moody* v. *Bache & Co., Inc.*, 570 F. 2d 523, 527-28 (5th Cir. 1978); *Sargent* v. *Genesco, Inc.*, 492 F. 2d 750, 759 (5th Cir. 1974); *Herpich* v. *Wallace*, supra, 430 F. 2d at 810. Because this case is devoid of any claimed decline in value or lost profit opportunity pertaining to McGrath's investment in Basford stock, it is also devoid of any proof of causation.

By ignoring the absence of causation and utilizing a test for materiality which fails to reflect the purposes of section 10(b),

the majority below extends the sanction of Rule 10b-5 to every plaintiff complaining of common law fraud or breach of duty who has been lucky enough to have purchased or sold stock at or about the same time and has not received full disclosure of all facts pertaining to those common law issues. Such a "new fraud" approach exceeds the limits of the "touch test" as applied by this Court's recent decisions and conflicts as well with the approach taken in other circuits. *Santa Fe*, supra, 430 U. S. at 480 n. 17; 97 S. Ct. at 1304; *Huddleston*, supra, 640 F. 2d at 549; *Mason* v. *Unkeless*, 618 F. 2d 597, 599-600 (9th Cir. 1980); *Bucher* v. *Shumway*, CCH Fed. Sec. L. Rep. ¶ 97, 142 (S. D. N. Y. 1979), aff'd without opin., 622 F. 2d 572 (2d Cir.), cert. denied, ____ U. S. ____, 101 S. Ct. 120 (1980). As this Court recently observed, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." *Chiarella* v. *U. S.*, 445 U. S. 222, 100 S. Ct. 1108, 1116 (1980).

Public respect for federal statutes such as section 10(b) may only be maintained if a predictable standard exists under which those required by the statute to make disclosures may do so with some minimal confidence that subsequent litigation will be avoided. Such a standard will not be achieved unless materiality and causation requirements under section 10(b) are defined with reference to the legislative purpose of that statute. When, as here, facts deemed to be material are completely unrelated to the value of the stock sold and only pertain to the personal employment prospects of one selling shareholder, no predictable standard exists to alert purchasers such as these petitioners to the fact that they will be required, as part of their federally mandated securities disclosures, to inform each selling shareholder of any concerns as to his suitability for future promotion.

Applying the Seventh Circuit's standard, no stock may be safely purchased without the purchaser's in depth consideration of all facts, whether or not related to the value, which are substantially likely to affect the judgment of each selling

shareholder who is not found to be acting unreasonably. Petitioners submit that the broadest permissible scope of Rule 10b-5 bearing any meaningful relationship to the statute and its purpose would mandate disclosure of a fact only if there is a substantial likelihood that a reasonable person considering an offer to purchase or sell a security would consider that fact important in deciding whether fair value is represented by the offer. Any more expansive materiality standard would result, as it did in this case, in the imposition of Rule 10b-5 liability for the failure to disclose alleged acts of common law fraud, breach of contract and breach of fiduciary duties which are completely unrelated to any investment loss or lost opportunity. Under such circumstances, the statutory limiting phrase "in connection with" has been rendered meaningless. Petitioners submit that section 10(b) does not reach as far as the statements about future employment prospects involved in this case.

B. McGrath's Waiver of a Potential Opportunity to Purchase Stock Did Not Involve the Sale of a Security.

At the time of the Basford merger, respondent agreed to waive his contingent opportunity to purchase more Basford stock. He had obtained that right under an agreement dated August 18, 1971 which provided that he might purchase additional shares of Basford stock, but only if still employed by Basford three years later, in August, 1974. Although the court below failed to reach this issue, petitioners submit that the waiver of this contingent right did not constitute the sale of a security.

As this Court noted in *Blue Chip*, supra, potential purchasers of corporate shares are one of the three principal classes of potential plaintiffs barred from standing under the securities laws by the rule first announced in *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.), cert. denied, 343 U. S. 956, 72

S. Ct. 1051 (1952). Because McGrath's rights under the 1971 agreement were not vested at the time he signed the 1972 waiver and would have in fact been forfeited when he ceased employment in January, 1973, McGrath was no more than a potential purchaser of Basford shares who, by signing the waiver, agreed not to invest. Such a decision, even if procured by fraud or misrepresentation as alleged, presents exactly the type of indeterminate and nebulous claim condemned in *Blue Chip.*

The contingent right which McGrath waived was so restricted in this instance that the August 1971 agreement giving rise to it cannot be said to be an investment contract or a security. Although an option to purchase stock can be a security, to become one it must contain the standard attributes of an investment contract. The substance, rather than the form of the transaction is crucial. *United Housing Foundation, Inc.* v. *Forman,* 421 U. S. 837, 95 S. Ct. 2051 (1975); *Tcherepnin* v. *Knight,* 389 U. S. 332, 88 S. Ct. 548 (1967). In this instance, McGrath's contingent contract right was not an option which he could be assured of exercising at some future point.

Moreover, this contingent right lacked several of the crucial attributes of a security. *Securities and Exchange Comm.* v. *W. J. Howey Co.,* 328 U. S. 293, 66 S. Ct. 1100 (1946). McGrath made no monetary investment to obtain the 1971 agreement. See *International Brotherhood of Teamsters, etc.* v. *Daniel,* 439 U. S. 551, 99 S. Ct. 790, 796-97 (1979). Although McGrath sold his Basford shares at a fair price in an arm's length transaction, the contingent right was waived, not sold for any valuable consideration, and McGrath has never claimed any deception about its value.

Finally, whatever misrepresentations are claimed to have caused McGrath to sign the waiver, he could not have been damaged thereby. The 1971 agreement would have lapsed of its own accord, at the latest, when McGrath was discharged in

November, 1972. Thus, no misrepresentation proximately caused respondent's failure to purchase any stock under the 1971 agreement.

C. The Economic Realities of McGrath's Claims Involve No Investment Decision.

The primary purpose of both the 1933 and the 1934 Acts was to eliminate serious abuses in the capital markets. The focus of these acts is the regulation of capital raising for profitmaking purposes, trading and investment in securities. *Forman,* supra, 421 U. S. at 849, 95 S. Ct. at 2059. In deciding whether primarily investment or primarily commercial activities are involved in any transaction, its substance must be examined to determine the "economic realities." *Id.; Tcherepnin,* supra, 389 U. S. at 336, 88 S. Ct. at 553. In this case, the required examination reveals an entirely commercial transaction.

Three elements must be proved in order to establish that a particular transaction is, in reality, an investment and is, therefore, within the federal securities acts: (1) an investment in a common venture; (2) premised on a reasonable expectation of profits; (3) to be derived from the entrepreneurial or managerial efforts of others. *Forman,* supra, 421 U. S. at 852, 95 S. Ct. at 2060; *Howey,* supra. Accord, *Fredriksen* v. *Poloway,* 637 F. 2d 1147 (7th Cir.), cert. denied, ____ U. S. ____, 49 U. S. L. W. 3882 (May 26, 1981); *Chandler* v. *Kew, Inc.,* CCH Fed. Sec. L. Rep. ¶ 96, 966 (10th Cir. 1977); *Zilker* v. *Klein,* CCH Fed. Sec. L. Rep. ¶ 97, 992 (N. D. Ill. April 6, 1981); *Anchor-Darling Industries, Inc.* v. *Suozzo,* CCH Fed. Sec. L. Rep. ¶ 97, 933 (E. D. Pa. March 16, 1981); *Bula* v. *Mansfield,* CCH Fed. Sec. L. Rep. ¶ 96, 964 (D. Colo. 1977).

Several recent decisions have held that the purchaser of all the stock of a business lacks standing to complain of fraud under section 10(b). *Fredriksen,* supra; *Chandler,* supra; *Zilker,* supra; *Anchor-Darling Industries,* supra. These decisions are premised on the fact that no investment is being made

in a common venture and that the managerial efforts of the purchaser will determine the success or failure of the undertaking. The result of such reasoning is the recognition of the economic realities of the transaction as a commercial sale of a business, not a stock investment.

The majority below, however, incorrectly distinguished these precedents on the basis that this plaintiff is an allegedly defrauded seller rather than an allegedly defrauded purchaser. (Appendix B. p. 2b.) Petitioners submit that such a distinction contravenes this Court's direction in *Forman* and *Tcherepnin* to evaluate each transaction on its substance, not its form. See, e.g., *Barsy* v. *Verin,* 508 F. Supp. 952, 954 (N. D. Ill. 1981). Where, as here, the employee-owners of a business sell the entire enterprise which resulted from their entrepreneurial efforts to a purchaser who assumes management and control, no investment activity is involved. In this case, the selling Basford shareholders, including McGrath, had contributed the company's entire managerial efforts at the time of the sale. As a group, these shareholders retained control over the enterprise and must therefore be presumed to have had access to the information essential to their decision to sell. *Charles Hughes & Co.* v. *Securities and Exchange Comm.,* 139 F. 2d 434, 437 (2d Cir. 1943), cert. denied, 321 U. S. 786, 64 S. Ct. 781 (1944) ("The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."); *Hirsch* v. *du Pont,* 396 F. Supp. 1214, 1224 (S. D. N. Y. 1975), aff'd, 553 F. 2d 750 (2d Cir. 1977) ("[W]here the investor obtains managerial control and thereby gains access to information . . . he has less need of the protection . . . of the securities laws.").

McGrath's status as a member of a selling group instead of as a sole selling owner does not alter the commercial character of the transaction. Courts have routinely applied the managerial efforts element of the economic realities test to limit the scope of federal securities protection in partnership transactions

involving joint management efforts. *Vincent* v. *Moench,* 473 F. 2d 430, 436 (10th Cir. 1973); *Hirsch* v. *du Pont,* supra, 396 F. Supp. at 1220-21; *Romney* v. *Richard Prows, Inc.,* 289 F. Supp. 313, 315 (D. Utah 1968). McGrath was the number two man in Basford management at the time of the merger and by his own testimony was the person in charge of the day to day operations of the business. (Pl. Ex. C.) He negotiated the admittedly arm's length sale of the business to Zenith on behalf of the selling group. Such activities involve none of the economic realities of an investment in a common venture managed by others, regardless of whether the plaintiff is the purchaser or the seller.

In substance, the Basford merger was a transaction in which the selling shareholders comprised the company's entire management, claimed no deception pertaining to the economic and financial facts relating to the stock and received a fair price paid by the purchaser in an arm's length transaction. Even without the sellers' management participation, such a transaction is beyond the scope of section 10(b) because no deception occurred in connection with the sale of any security. *Santa Fe,* supra, 430 U. S. at 473 n. 12, 97 S. Ct. at 1300. The fact of active management control, however, places the transaction additionally beyond the realm of an investment and thus beyond the reach of section 10(b) because the economic realities involved only the commercial sale of a business by one management group to another.

2. RESPONDENT'S ABUSE OF FEDERAL JURISDICTION BASED ON HIS SHAM ALLEGATION OF SECURITIES FRAUD CALLS FOR THE EXERCISE OF THIS COURT'S SUPERVISORY POWERS

The opinion below sustains federal jurisdiction in this case on the basis of the existence of a substantial federal question under Rule 10b-5 and the exercise of pendent jurisdiction over state law fraud and contract claims. The assertion of federal

question jurisdiction in this case, however, is a clear example of a plaintiff opening the federal court house door through the pretense of a fabricated federal claim admitted to be counterfeit at only trial. In approving this practice, the court below encourages the abuse of federal jurisdiction.

McGrath added his securities fraud claim and federal question allegation to his amended complaint only after petitioners challenged his obviously insufficient allegation of diversity jurisdiction. The conduct of McGrath's attorneys at trial points up the sham involved in his securities law count. Having used the bare claim of receiving "inadequate consideration for his 2,885 shares of Basford Co. stock" to get around petitioners' denials of jurisdiction and directed verdict motion, McGrath's lawyers voluntarily stipulated that the $38 per share price was fair during petitioners' case in chief, as petitioners sought to present expert testimony on the question of the value per share. (R. 1059-1062.)

No colorable federal securities claim could have been based either on McGrath's relinquishment of a conditional opportunity to purchase additional Basford stock or on his sale of the shares he held. McGrath's waiver of the conditional opportunity involved no arguable sale of a security under *Blue Chip,* supra. Moreover, his failure to claim either any deception regarding the value of the stock actually sold, or any investment loss or lost profit opportunity, prevented him from raising any colorable claim that the employment representations occurred in connection with the stock sale. *Santa Fe,* supra. Because no colorable federal claims were stated, the exercise of federal jurisdiction was improper. *United Mine Workers* v. *Gibbs* 383 U. S. 715, 722, 86 S. Ct. 1130, 1136-37 (1965).

Other circuits have refused to find any basis for the exercise of federal jurisdiction where the allegations raised by plaintiffs were so clearly excluded from coverage by federal securities laws. *Koke* v. *Stifel, Nicholaus & Co.,* 620 F. 2d 1340, 1345-46

(8th Cir. 1980); *National Bank of Commerce* v. *All American Assurance Co.*, 583 F. 2d 1295, 1298 (5th Cir. 1978); *Ketchum* v. *Green*, 557 F. 2d 1022 (3d Cir. 1977), cert. denied, 434 U. S. 940, 98 S. Ct. 431 (1978); *Grenader* v. *Spitz*, 537 F. 2d 612 (2d Cir.), cert. denied, 429 U. S. 1009, 97 S. Ct. 541 (1976). The exercise of federal jurisdiction to adjudicate claimed breaches of contract and common law fraud regarding employment prospects conflicts with these decisions and was improper.

Because McGrath's securities fraud claim was so insubstantial when filed as to call into question its good faith, the trial court had no reason to exercise pendent jurisdiction over McGrath's state law claims. His securities fraud claims were exposed as sham when he stipulated at trial that he was paid a fair price, thus contradicting the essential allegation of his amended complaint supporting his Rule 10b-5 count. The dismissal of pendent claims in the absence of a substantial federal question has repeatedly been recognized as the appropriate procedure. *Lentino* v. *Fringe Employee Plans, Inc.*, 611 F. 2d 474, 480 n. 7 (3d Cir. 1979); *National Bank of Commerce* v. *All American Assurance Co.*, supra; *Ketchum* v. *Green*, supra; *Koke*, supra. Such a dismissal is warranted even after trial on the merits, when the absence of any substantial federal question is apparent. *Tully* v. *Mott Supermarkets, Inc.*, 540 F. 2d 187, 195-96 (3d Cir. 1976).

Here, McGrath's amended complaint was filed on March 24, 1976, eight months after *Blue Chip* and *Forman*. Nearly two years remained to refile his claims in state court. After the amended complaint was filed, petitioners promptly denied all McGrath's jurisdictional allegations. (A. 59-60.) McGrath knew not only that his Rule 10b-5 claim had no basis under *Blue Chip* when he filed it, but also that he had ample time to present his claims in state court under the procedure approved by this Court for preserving state claims in doubtful situations. See *Blue Chip*, supra, 421 U. S. at 738 n. 9, 95 S. Ct. at 1927.

The conduct of respondent in asserting in his amended complaint that the payment for shares he sold was "inadequate," and then stipulating during petitioners' case that the price was fair is a transparent effort to bootstrap himself into federal jurisdiction which simply does not exist. Such attempts must be condemned, even after a full trial on the merits:

> Were we to sustain the district court's exercise of pendent jurisdiction merely because of the time already invested in litigating the state claims, we would be insulating from review a significant class of cases solely because an alleged error had been perpetrated through the trial process. The needless expenditure of time and energy occasioned in the first instance by the improper exercise of pendent jurisdiction would thus become the justification for allowing the incorrect ruling to stand. *Tully,* supra, 540 F. 2d at 196.

In approving the exercise of pendent jurisdiction in the instant case, the opinion below conflicts with these well established precedents, and with the rules laid down by this Court. This conflict regarding the extent to which a plaintiff's mere allegation of a federal question can create pendent jurisdiction over purely state law claims should be resolved by this Court by restricting federal jurisdiction in cases like this.

3. THE STANDARD OF REVIEW APPLIED BELOW CONFLICTS WITH LONG STANDING RULES ESTABLISHED BY THIS COURT AND FOLLOWED IN OTHER CIRCUITS

The jury returned a general verdict, assessing damages against all four defendants without specifying which one or more of respondent's various theories formed the basis of its awards. In reviewing this verdict the opinion below states that "... to triumph on appeal, [petitioners] must show that under *none* of the three rationales was [respondent] entitled to the award of compensatory and punitive damages." (Appendix A. p. 7a, emphasis supplied.) The standard of review set by this

Court requires that a general verdict be set aside and a new trial granted if *any one* of McGrath's legal theories on which the verdict might be based was insufficient to support the verdict:

> Since we hold erroneous one theory of liability upon which the general verdict may have rested—a conspiracy among petitioners and Exchange Lemon—it is unnecessary for us to explore the legality of the other theories. As we stated of a general verdict in *Maryland* v. *Baldwin*, 112 U. S. 490, 693 . . . "[I]ts generality prevents us from perceiving upon which plea they found . . . ."

Sunkist Growers, Inc. v. *Winckler & Smith Citrus Prod. Co.*, 370 U. S. 19, 29, 82 S. Ct. 1130, 1136 (1962). Accord, *United New York and New Jersey Sandy Hook Pilots Ass'n.* v. *Halecki*, 358 U. S. 613, 619, 79 S. Ct. 517, 520 (1959); *Wilmington Star Mining Co.* v. *Fulton*, 205 U. S. 60, 78-79, 27 S. Ct. 412 (1907).

This standard of review has since been followed, largely without exception, by Courts of Appeals in reviewing general verdicts based on multiple theories in federal question and diversity cases. See, e.g., *Mueller* v. *Hubbard Milling Co.*, 537 F. 2d 1029, 1038 (8th Cir.), *cert. denied*, 439 U. S. 865, 99 S. Ct. 189 (1978); *Morrissey* v. *National Maritime Union*, 544 F. 2d 19, 26 (2nd Cir. 1976); *Jamison Co.* v. *Westvaco Corp.*, 526 F. 2d 922, 934 reh. den. 530 F. 2d 34 (5th Cir. 1976). In the Sixth Circuit, this rule is applied only in federal question cases. In diversity cases, the district courts within the Sixth Circuit are expected to apply whatever rule is followed in the state in which the case is tried. Some states in that circuit follow the so-called "two issue" rule and uphold any verdict supported by at least one arguably proper ground. *Volasco Products Co.* v. *Lloyd A. Fry Roofing Co.*, 308 F. 2d 383, 390 (6th Cir. 1962), cert. denied, 372 U. S. 907, 83 S. Ct. 721 (1963).

The Seventh Circuit years ago reached a result similar to *Volasco* when applying Illinois' "two issue" rule in a diversity case in *Firemen's Ins. Co.* v. *Follett*, 72 F. 2d 49, 51 (7th Cir.),

cert. denied, 293 U. S. 618, 55 S. Ct. 209 (1934). Based on decisions of the Sixth and Seventh Circuits in diversity cases, the Ninth Circuit has recently adopted the "two issue" rule, rather than this Court's review standard, in a federal question case. *Traver* v. *Meshiry,* 627 F. 2d 934, 938 (9th Cir. 1980). Now, in the case at bar, the Seventh Circuit joins the Ninth Circuit in applying a state law standard to review a non-diversity case, contrary to this Court's decisions, and the decisions of other circuits.

The majority below cited no authority and gave no reason for departing from this Court's decisions on the standard of review in denying a new trial. Its opinion recognized that "it is clear that the compensatory damage award could not be predicated on the contract count." (Appendix A. p. 21a.) It goes on to declare "the jury, nevertheless, without having found merit to the securities law charges, *could have* based its compensatory damage award exclusively on the common law fraud count . . ." (*Id.,* emphasis supplied.) Thus a reviewing court must speculate as to which count would sustain a verdict despite acknowledging that "[T]he jury instructions are not clear on this point . . ." (Appendix A. p. 21a n. 10.) Under the proper standard of review, if any one of respondent's three theories fails to support the general verdict, then the verdict must be set aside and a new trial ordered on all issues.

Because of the importance of uniformity in the standard of review employed by the Courts of Appeals, this Court should resolve the conflict presented between the opinion below and the decisions of this Court and the courts of other circuits.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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June 19, 1981

APPENDIX A

In the

United States Court of Appeals

For the Seventh Circuit

No. 79-1361

ROBERT EDWARD MCGRATH,

Plaintiff-Appellee,

v.

ZENITH RADIO CORPORATION, ZENITH DISTRIBUTING CORPORATION OF NORTHERN CALIFORNIA, WALTER C. FISHER and AMILE J. FORNI,

Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 75 C-2290—Stanley J. Roszkowski, *Judge.*

ARGUED FEBRUARY 13, 1980—DECIDED JANUARY 28, 1981

Before FAIRCHILD, *Chief Judge*, SWYGERT and CUMMINGS, *Circuit Judges.*

FAIRCHILD, *Chief Judge.* This case arises out of the July 1972 acquisition by Zenith Radio Corporation (Zenith or Zenith Radio) of the H. R. Basford Company (Basford), an electronic products wholesaler, and the November 1972 firing of plaintiff, Robert E. McGrath, Basford's vice-president. Alleging breach of contract, fraud, and violations of the securities laws, McGrath argued in the district court that his termination was wrongful because defendants had failed to fulfill a promise to appoint him president of the Zenith subsidiary upon the retirement of the then-current top executive. A six-person jury returned a verdict in plaintiff's favor for one million dollars in compensatory

damages against all defendants and, in addition, returned separate verdicts against each defendant for punitive damages totaling another million dollars. On appeal to this court, defendants claim primarily that the evidence was insufficient under each of the three counts and that the respective measures of damages were inappropriate. While we reject the challenge to the sufficiency of the evidence and find certain alleged errors not preserved for appellate review, we conclude that since there was no testimony as to how long it was probable that McGrath would continue as president of the subsidiary or would occupy a similar position with another company, the jury's award of compensatory damages for loss of future earnings was in part speculative. Plaintiff shall therefore have the option of accepting $1,300,000 in damages ($300,000 compensatory, $1,000,000 punitive) or submitting to a new trial on the question of compensatory damages only.

Facts

The defendants in this case are two corporations, Zenith and its subsidiary, Zenith Distributing of Northern California (Zenith Distributing), and two individuals, Amile J. Forni and Walter C. Fisher.

H. R. Basford Company was a California corporation which distributed Zenith products in the San Francisco area. In August 1971, McGrath was hired by Forni, the president of Basford, to assume the position of vice-president and general manager. It was the intention of both parties that Forni would soon retire and that McGrath would succeed to the company's presidency. In addition to an annual salary of $35,000 as vice-president, McGrath was given the option of purchasing 5,000 shares of Basford stock, provided that he was still working for Basford in three years and that the California Commissioner of Corporations would approve the sale. In September and October, 1971, McGrath bought 2,835 shares of Basford stock.

In February 1972, representatives of Zenith Radio and Basford began discussing the possibility of expanding Basford's market for Zenith products. Following a

series of meetings in April, May, and June of 1972 it was agreed that this expansion could best be handled by Zenith's acquisition of Basford. At these meetings, McGrath was the main spokesman for Basford. His chief concern was that Basford employees would retain their job security and that Basford shareholders, all of whom were employees, would receive a fair price for their shares. Zenith's primary demand was that it be assured of acquiring all of Basford's stock, for it wanted no minority shareholders.

On June 2, 1972, a tentative agreement was reached, and on July 12, 1972, the terms of the proposed sale were disclosed to Basford employees and shareholders. Fisher, a representative of Zenith, assured the employees that their jobs were secure and that career opportunities would probably be enhanced as a result of the acquisition.

Also on July 12, 1972, Fisher, Forni, and Paul Dwyer, Zenith's treasurer, concluded that because of Zenith's desire to acquire all of Basford's stock, it was necessary to extinguish the option agreement which gave McGrath the right to purchase additional shares. The following day Fisher met with McGrath and asked him to waive the option. McGrath testified that at that meeting:

> "Mr. Fisher . . . indicated to me that, you know, we have to dispose—we have to in some way eliminate this option to buy shares. I said 'Yes, I knew that.'
>
> "He then told me that there was nobody more hurt in the sale of the company, or nobody gave up more in the sale of the company than I was giving up if I was going to waive the option to buy the shares. He explained that it deprived me of potential profit on those shares.
>
> "He then told me that as far as he understood that I would be heir apparent to Mr. Forni upon his retirement and that was thoroughly acceptable to both Zenith and to himself.
>
> "He said that as the president of the new corporation I would be entitled to substantial stock options

at the Zenith Radio Company and be a part of a group which was referred to as an executive compensation bonus compensation group, which he explained was in the area of 110 to 120 people of senior executives at Zenith who participated in a yearly extra compensation or bonus program.

"He then presented me with a waiver . . . for the right of my purchase of those shares of stock. I said, 'Walter [Fisher], I do think I gave up more than anybody else in this company by the sale, and I would like to have a three-year employment contract with the H. R. Basford Co. under your ownership.'

"Walter said that it was not the practice at Zenith Radio Corporation to have employment contracts with any of their executives, including himself, and that Zenith Radio Corporation did not have a reputation of mistrusting or [mis]handling people, and that it would have to be that there would be no contract, but we certainly understood that I was the heir apparent and I was to benefit from the programs that he had outlined.

"I indicated to him that I was then trusting him as being the person who had represented to me my future status and standing with the Zenith Radio Corporation, and I signed the waiver. . . ."

In exchange for signing the waiver, McGrath received nothing of value other than the knowledge that it facilitated the sale to Zenith.

Immediately after this conference, Fisher went to Forni's office and was advised that Forni had doubts about the job McGrath was doing and whether he would make a suitable successor. His reasons for unhappiness with McGrath included the latter's failure to get out and meet the dealers who were Basford's customers, his time-consuming outside activities, and his poor judgment in handling particular problems. Forni and Fisher discussed these shortcomings and Forni agreed to wait three or four months before making any definite decision. After this meeting, Fisher rode downtown with McGrath but made no mention of the conversation.

When McGrath asked how soon he was going to be made president, Fisher said he still had some things to discuss with Forni and appeared more aloof and uncertain than at their earlier meeting. The next day when McGrath asked Forni whether he and Fisher had spoken regarding McGrath's ascendancy to the presidency, Forni said "no."

On July 14, 1972, the Basford stockholders, including McGrath, signed the documents by which they agreed to sell their shares of stock to Zenith.

At no time prior to the closing did McGrath have any reason to believe Forni had reservations about his becoming president upon Forni's retirement. Despite two or three phone conversations with Fisher between July 13 and the closing on July 31, Fisher did not disclose Forni's misgivings about McGrath.

On October 6, 1972, Forni met with Fisher in Chicago and recommended that McGrath be replaced. Fisher agreed after much conversation. When McGrath asked Forni about his meeting of October 6 with Fisher, Forni said that the subject of McGrath's future did not come up.

On Sunday, November 12, 1972, at 10:00 or 11:00 at night, Forni telephoned McGrath to tell him that he was fired effective January 1, 1973, with pay to continue until the end of March 1973. McGrath's attempts to effectuate a reconciliation failed and despite his requests that he be permitted to save face by taking a different job in the Zenith organization, even on a temporary basis, no such opportunity was made available to him. McGrath immediately began to search for new employment but was refused future use of an office, telephone, or secretarial help to aid him in the preparation of resumes and letters to be sent to potential employers. As a result of four months of searching and interviewing, he received three job offers and accepted one with the Fleetwood Corporation of Montreal, Canada, in April 1973. The Fleetwood position paid $36,000 annually and had a bonus potential of approximately another $6,000.

Jurisdiction

Before turning to the merits of this case, we will address defendants' contention that the district court was without jurisdiction to hear McGrath's claims. Jurisdiction was based on 28 U.S.C § 1331(a),[1] the general federal question jurisdictional statute, and on the doctrine of pendent jurisdiction. Defendants argue that this is an ordinary employer-employee dispute involving state law, and that McGrath's charge of securities fraud is a contrived attempt to establish federal question jurisdiction which follows his unsuccessful effort to establish diversity jurisdiction. We disagree.

It is settled that if the complaint sets forth a substantial claim, a case is presented within the federal jurisdiction. *See Levering & Garrigues Co. v. Morrin*, 289 U.S. 103, 105 (1933); *Hagans v. Levine*, 415 U.S. 528, 536-543 (1973). To be substantial, the claim need only be not "obviously frivolous," "obviously without merit," or "essentially fictitious." *Hagans, supra*, 415 U.S. at 537, and cases cited therein. McGrath alleged in his complaint that he suffered losses as a result of misrepresentations concerning his future employment made by defendants in connection with Zenith's acquisition of his Basford shares and the waiver of his option—as a result, that is, of the defendants' violation of the federal securities laws. None of the issues—factual or legal—raised by this charge is so obviously foreclosed by previous decisions of the Supreme Court or other courts that there is "no room for the inference that the questions sought to be raised can be the subject of controversy." *Levering, supra*, 289 U.S. at 105-106. We hold, therefore, that this case presents a substantial federal question and the district court properly exercised jurisdiction in hearing it.

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[1] Section 1331(a) provides:

"The district court shall have original jurisdiction of all civil actions wherein the matter in controversy . . . arises under the Constitution, laws, or treaties of the United States. . . ." 28 U.S.C. § 1331(a) (1976).

Defendants also argue that the district court abused its discretion in agreeing to hear the pendent state claims involved in this case. The doctrine of pendent jurisdiction rests on considerations of judicial economy, convenience, and fairness to litigants. *United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966). Defendants do not deny that the exercise of pendent jurisdiction here would serve judicial economy and convenience, and, certainly, the federal and state claims in this case all arise out of a "common nucleus of operative fact." *Gibbs*, 383 U.S. at 725. The defendants' asserted liability, under both federal and state law, rests on the same set of events, and proof would require largely the same evidence. Defendants argue instead that pendent jurisdiction should not have been exercised because the six-member jury was too small to render a fair verdict. This claim is completely without merit. The Supreme Court, in *Colgrove v. Batten*, 413 U.S. 149 (1973), ruled that a six-member panel does not violate the Seventh Amendment right to a civil jury. A federal court which deems a jury of six adequate should hardly decline otherwise proper pendent jurisdiction because a jury of twelve might be better. We hold that all aspects of this case were properly before the district court.

Turning now to the merits of this appeal, we observe first that defendants' burden is a heavy one in seeking reversal of the judgment or remand for a new trial. The case was submitted to the jury on three theories of liability—breach of contract, common law fraud, and violation of the securities laws—but the verdict in favor of plaintiff did not specify under which theory or theories liability for compensatory damages was imposed. Accordingly, to triumph on an appeal, defendants must show that under none of the three rationales was plaintiff entitled to the award of compensatory and punitive damages.

The Breach Of Contract Claim

The contract upon which McGrath's claim of breach was predicated was the oral agreement between McGrath and Zenith Radio and Zenith Distributing

(Basford's successor), negotiated by their agent, Fisher, on July 13, 1972. Defendants contend on appeal that even assuming *arguendo* that an agreement may have been entered into on that occasion, no actionable breach has been proven because the contract was only one for employment at will, and as such was terminable by either party at any time. For support, defendants point to McGrath's own testimony that he asked for but was refused a three-year written contract and to the absence of any other evidence as to the contemplated duration of plaintiff's prospective employment.

The difficulty with this line of reasoning is that it misconstrues the nature of plaintiff's argument. McGrath does not assert merely that Zenith promised to continue his employment, but rather that Zenith promised to make him president of Basford's successor upon the retirement of Forni and to afford him career opportunities and benefits, including stock options in Zenith and participation in an executive bonus compensation group. In exchange for these promises, according to plaintiff, he agreed to sell his stock and to waive the option he had to purchase shares in Basford. The alleged wrong lay in defendants' failure to either establish cause for not making him president or to make him president and then ease him out after a decent interval.

We believe that the evidence produced at trial—including McGrath's testimony that Fisher told McGrath that his becoming president was "thoroughly acceptable to both Zenith and himself"; "that as president . . . [McGrath] would be entitled to substantial stock options and . . . [to participate in] an executive . . . bonus program"; and "that [McGrath] was the heir apparent"—formed a sufficient basis on which the jury could conclude that Zenith had promised to appoint plaintiff president of the new corporation and that a binding contract had been entered. While there was no representation that McGrath would be president for any specified tenure, the jury could find from the evidence a promise that McGrath would be made president with a reasonable opportunity to give satisfactory performance. As the finder of fact, the jury was entitled to conclude

that the agreement, although performed by McGrath by his selling his shares and executing the waiver, was breached by defendants when they terminated his employment.

Contrary to defendants' assertions, the contract was not terminable at will because under California law, which is the law applicable to this case, even where a contract is for employment for an indefinite period, the "terminable at will" doctrine is inoperative if the contract is based on consideration other than the services to be rendered. *Speegle v. Board of Fire Underwriters*, 29 Cal.2d 34, 39, 172 P.2d 867, 870 (1946); *Brawthen v. H & R Block, Inc.*, 52 Cal. App. 3d 139, 149, 124 Cal. Rptr. 845, 851 (1975). Plaintiff here agreed not only to work for Zenith but to surrender his stock purchase option and sell his stock.

Nor do we find merit to defendants' suggestion that the oral contract was barred by the parole evidence rule. The terms of the sale agreement of July 14, 1972, which was signed by McGrath and the other shareholders, are not contradicted or modified by proof of the earlier oral agreement of July 13. The written agreement contained no provisions concerning who would be the officers of the successor corporation or the fringe benefits to be enjoyed by such officers. In contrast, the main subject matter of the oral agreement between Zenith and McGrath was the presidency of the successor corporation and the fringe benefits that officer would receive. While section 9(2) of the July 14 agreement provided that "since December 31, 1971 . . . there has not been . . . (vi) any employment, bonus or deferred compensation agreement entered into between THE CORPORATION [Basford] and any of its directors, officers, shareholders or other employees or consultants . . ." this representation related only to agreements by Basford, not by Zenith. Consequently, it is not contradicted by proof of the oral contract with McGrath.

We similarly find the statute of frauds inapplicable to the present case. The California statute provides that "an agreement that by its terms is not to be performed within a year from [the] making thereof" shall be in-

valid. Cal. Civ. Code, § 1624(1). It has been held to apply only to those contracts which, by their terms, cannot possibly be performed within one year. *White Lighting Co. v. Wolfson*, 68 Cal.2d 336 n. 2, 438 P.2d 345, 66 Cal. Rptr. 697, 701 n. 2 (1968). Because defendants' promise to make McGrath president upon Forni's retirement could have occurred within one year and because it was possible to enroll McGrath in the Zenith stock option program and make him a member of the executive compensation bonus group at any time after the sale was consummated on July 31, 1972, the rule is without force in the present case.

Accordingly, we find that the jury could properly have imposed liability under the breach of contract theory.

The Securities Fraud Claim

Plaintiff's securities fraud claim urged that defendants were liable for violations of section 10(b) of the Securities Exchange Act of 1934[2] and Securities Exchange Commission Rule 10b-5[3] promulgated thereunder. On

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[2] Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange—

". . . .

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1976).

[3] Rule 10b-5 provides:

"It shall be unlawful . . .

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary to

(Footnote continued on following page)

this appeal defendants do not dispute the fact that the jury could have determined that their promises to make McGrath president of the acquired company constituted misrepresentations, but rather object that the statements were not made "in connection with" a sale or purchase of a security and were not material.

Considering first the question of materiality, the parties agree that the applicable test is that articulated by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). A statement or omission is material if there is a substantial likelihood that a reasonable shareholder would consider it important in determining his or her course of conduct. *See id.* at 449.[4] Materiality presents a mixed question of law and fact, and as the Court in *TSC Industries* emphasized, "[t]he determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these facts to him, and these assessments are peculiarly ones for the trier of fact." *Id.* at 450. The scope of appellate review, therefore, is limited: only where reasonable minds cannot differ on the issue of materiality may a court determine the issue as a matter of law. *See id.* at 450.

The defendants argue that no reasonable investor could possibly have attached importance to his future employment prospects upon being told, as Fisher told

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[3] *continued*

make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

[4] *TSC Industries* arose under Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1976) and Rule 14a-9, 17 C.F.R. § 240.14a-9, relating to false statements in proxy solicitations. While in this case the plaintiff relies on section 10(b) and Rule 10b-5, the test for materiality under these statutes and rules is the same. *See e.g., Wheat v. Hall*, 535 F.2d 874 (5th Cir. 1976) (citing *TSC Industries* for the test of materiality under Rule 10b-5).

McGrath, that Zenith did not enter into employment contracts with its executive officers. We cannot accept this view. Defendants' argument ignores Fisher's earlier statements that Zenith had no objection to McGrath succeeding Forni and that once he was president he would be entitled to special benefits. It also fails to consider Fisher's immediate assurance, notwithstanding the no-written-contracts rule, McGrath was the heir apparent to the presidency of the company. The issue presented to the jury was whether a reasonable investor would have considered such utterances important in deciding whether to sell his or her securities. It cannot be said as a matter of law that these statements carried no weight in the seller's decision-making process.

The defendants rely on *Robinson v. Cupples Container Co.*, 513 F.2d 1274 (9th Cir. 1975), for the proposition that a promise of employment is not a material factor in the decision to sell securities. In *Robinson*, the plaintiff, a partner in an acquired company, alleged that the acquiring company's false promise to employ him violated Rule 10b-5. The *Robinson* court held the promise of employment not material, but made clear, however, that its decision rested squarely on the particular facts of that case and that a different result might ensue under other circumstances. We think the facts of this case differ significantly from those in *Robinson* and justify a finding of materiality. In *Robinson*, the alleged promise was made only at an exploratory meeting between the parties and was never repeated during several months of negotiations that followed. Here, the promise of employment was repeated several times during the course of the negotiations, at a time near to the consummation of the actual transaction. Under such circumstances, the jury was entitled to find that the promise of employment would have been a material factor in McGrath's decision to relinquish his securities.

As to defendants' contention that the misrepresentations were not made "in connection with" the purchase or sale of a security, again, we find no merit.

In *Superintendent of Life Insurance v. Banker's Life and Casualty Co.*, 424 U.S. 6 (1971), the Supreme Court held that "Section 10(b) must be read flexibly, not

technically and restrictively." *Id.* at 12. It is necessary, therefore, in construing the phrase "in connection with the purchase or sale of any security," to consider the facts of the individual case. *See Goodman v. Epstein*, 582 F.2d 388, 410-411 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979). The test for determining whether the fraud was "in connection with" the sale, is whether the transaction involving the fraud may be said to "touch" the transaction involving the purchase. *Smallwood v. Pearl Brewing Company*, 489 F.2d 579, 595 (5th Cir. 1974) (interpreting *Banker's Life*).

McGrath was free to refuse to sell his shares or to abort the entire transaction by refusing to waive his option. The misrepresentations of the defendants, which the jury was entitled to deem material to his decision-making process, are surely close enough to satisfy the touching or "in connection with" requirement of section 10(b).

The defendants rely inappropriately on *Ketchum v. Green*, 557 F.2d 1022 (3d Cir. 1977), *cert. denied*, 434 U.S. 940 (1978), for the proposition that false promises concerning employment are not made "in connection with" the sale or purchase of any security. *Ketchum* does not stand for such a rule and its facts are clearly distinguishable. In *Ketchum*, the defendants contrived to oust the plaintiffs from their positions as officers of a corporation by various misrepresentations. Once this ouster was accomplished, the defendants had the plaintiffs' employment with the corporation terminated. Their termination triggered a requirement in the corporate charter that the plaintiffs sell their company stock back to the corporation at a predetermined price. The *Ketchum* court held that this forced sale was not sufficiently connected to the misrepresentations to support liability under section 10(b). The court emphasized that "the purportedly deceptive practices occurred, if at all, in connection with the struggle for control of the corporation." 557 F.2d at 1028. That is, the defendants' intention was to oust the plaintiffs, not to acquire their stock. Here, by contrast, Zenith's objective was to acquire all Basford shares, and the false promises were made in order to achieve that objective. Consequently,

the *Ketchum* rationale does not control the result in the present appeal.

Defendants further argue, citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1976), that even if McGrath waived his stock option in return for defendants' promise concerning his future employment, the forebearance of such a conditional purchase opportunity cannot form the basis for a section 10(b) or Rule 10b-5 violation. We find it unnecessary to consider this question, *but see International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 562 (1979), because plaintiff's claim is based upon the sale of his Basford shares, as well as on the waiver of his option, and there is no question that the former may serve as the predicate for an action under the securities laws.

The Common Law Fraud Claim

Plaintiff's common law fraud claim was based on the failure of Fisher or Forni to tell McGrath about their conversation on July 13 concerning McGrath's lack of suitability to become president of the acquired company. Defendants assert that this non-disclosure may not give rise to liability because there was never a duty to speak. Alternatively, they argue that even if such an obligation existed, the resulting misrepresentation or concealment was not material, was not a reasonable basis for reliance, and was not causally related to any losses plaintiff may have sustained. We find each of defendants' points to be without merit.

This is not a case of mere non-disclosure, but of both failure to correct a material representation, once the maker of the statement knew it to be false, and of concealment of relevant information. Only minutes after Fisher told McGrath that he was the "heir apparent" to the company's presidency and that as far as he understood Zenith had no objections to his succeeding Forni, Fisher learned from Forni that there were serious doubts as to whether McGrath would ever be promoted to the top position. Fisher never bothered to correct his representations though it is reasonable to infer from the facts that he knew McGrath might well

rely on his statements. As to Forni, when questioned the next day by plaintiff, he denied that he had discussed plaintiff's career with Fisher. All this transpired at a point in time prior to the signing of the agreement of sale, prior to the closing of the transaction, and prior to the point at which the agreement to surrender the option was to go into effect.

We believe that under these circumstances it was incumbent upon Fisher to correct his earlier statements. It is without significance that at the time those statements were made Fisher believed them to be true. *See Black v. Shearson, Hammill & Co.*, 266 Cal. App.2d 362, 72 Cal. Rptr. 157, 160 (1968). The making of the original statements, the discovery of their falsehood, and the failure to correct them before plaintiff relied on them were "elements in a continuing course of conduct" capable of establishing fraud. *Id.* at 160. While Forni was not a party to the original conversation, there was evidence to show that he lied to McGrath about a matter material to McGrath's sale of his shares and surrender of his option. Thus the scienter requirement is satisfied. Because Forni was personally interested as a stockholder in the sale going through he had a duty to discuss information that he must have known was material when questioned by McGrath. *See Fisher v. Pennsylvania Life Co.*, 69 Cal. App.3d 506, 512-513, 138 Cal. Rptr. 181, 184-185 (1977). Forni was also president and a director of the corporation in whose favor McGrath was releasing the option. One way or the other, Forni had virtually the same type of duty which Zenith had not to mislead McGrath to induce a sale of his stock and release of his option.

As to defendants' challenges to materiality, justifiable reliance, and proximate causation of damages, it is sufficient to note that each of these issues were questions of fact and have been resolved by the jury in plaintiff's favor. There was adequate evidence introduced at trial to support the factual findings and that being so the conclusions of the jury should not be disturbed on appellate review.

Measure Of Compensatory Damages

We now turn to the most difficult question raised by this appeal, the appropriateness of the jury award of compensatory damages. Essentially, we are concerned here with whether plaintiff was entitled to recover for loss of future earning capacity resulting from the damage to his career and business reputation suffered as a consequence of his dismissal. McGrath's claim was that because he was not eased out in a decorous manner so that he could look for a new job as an ex-president instead of a summarily discharged vice-president his career was permanently harmed. Plaintiff sought to recover for these losses under each of the three theories of liability, the jury was so instructed, and defendants now devote virtually all of their argument on the compensatory damage issue to challenging the propriety of an award for damage to plaintiff's career. Thus, while it is true that other elements of damages—*e.g.*, the expenses of moving and finding a new position—may have been considered by the jury in reaching its million dollar compensatory damage verdict, the parties agreed that such an amount could only be justified if plaintiff was entitled to compensation for injury to his career. We, therefore, focus our discussion on this question.

At trial, Dr. Hugh Holmes, an executive search consultant, testified that because of McGrath's inability to explain the circumstances of his firing at Basford or to furnish reliable references[5] he became an unattractive

[5] The record, however, indicates that on November 28, 1972, Fisher told McGrath that he could use him as a reference and could count on receiving a good recommendation. McGrath apparently did not trust this promise and did not use persons from Basford or Zenith as references during the interviewing process. Toward the end of his job search McGrath did obtain a letter of reference from the Comptroller of Zenith Distributing, dated March 14, 1973, and addressed "To whom it may concern," which was highly laudatory of plaintiff's performance and abilities. A similarly addressed letter, shorter and more reserved, was secured from Forni, dated April 4, 1973. It does not appear that these letters were ever put to any use.

candidate for other executive positions. The result, according to Holmes, was that plaintiff's career was permanently damaged and his earning capacity was diminished. As a means of assessing plaintiff's overall loss of earnings, the Hay System, which is a widely accepted method of evaluating executive and management positions, was employed by the witness. The Hay System weighs certain factors involved in a job, assigns point values to these factors, and, by comparison of compensation levels from all industries and institutions using the Hay System, establishes a compensation range of jobs at the various point levels. After analyzing the presidency of Basford and determining the salary plaintiff would have made in that position, Holmes formed the opinion that the dollar amount of McGrath's injury prior to the time of trial was $347,431. This was arrived at by subtracting what McGrath actually earned from what he would have earned in a position comparable to the presidency of the Zenith subsidiary. Dr. Holmes further calculated McGrath's continuing loss to be $50,000 per year.

Dr. Charles Linke, an economist, using Dr. Holmes' figures, estimated the present cash value at the time of trial of plaintiff's pre-trial loss at $371,107. He also set the present cash value of each $1,000 of McGrath's annual future losses at $12,662, assuming that plaintiff worked until he was 65 years of age.

With these figures before it, the jury concluded that plaintiff was entitled to one million dollars in compensatory damages.

Defendants now argue that the claims for breach of contract, securities fraud, or common law fraud could not have supported such an award and that injury to one's business reputation or career is not a compensable element of damage under any of the three theories. Under the contract count, defendant's claim McGrath could not recover for inability to find a job, and that while damages are permitted for loss of ability to perform work, plaintiff's employment with Fleetwood subsequent to his discharge conclusively showed no such injury was sustained. Plaintiff's maximum award under the con-

tract theory, they assert, would have been restricted to net lost earnings during the three year period immediately following his discharge, because McGrath's request for a written contract—which was refused—definitively proved that the outside limit of his expectation of employment was three years. Recovery under the securities claim, according to defendants, is limited to "actual damages" and does not include compensation for destruction of one's business reputation. Under this rationale, defendants contend, plaintiff was entitled to recover nothing for he stipulated at trial that he had received a fair price for his Basford shares and thus failed to prove any loss. Finally, under the common law fraud count, defendants argue that damages are restricted by the "benefit of the bargain" rule. They claim that because future earnings are not an "out of pocket" loss they are not recoverable in a fraud action, and that at most plaintiff could have received damages for his net loss of earnings during the three years following his discharge and for the lost value of his stock option.

We find that defendants are precluded from successfully advancing their position on the appropriate measures for computation of compensatory damages by the combined operation and effect of the rule of preservation and the presumption of verdict validity.

Plaintiff has argued before this court, and defendants have failed to refute, that with respect to the contract and common law fraud counts, defendants did not object at trial to inclusion in the jury instructions of the elements of damage of which they now complain. On the contract count, the jury was instructed that:

> "The plaintiff seeks damages for various losses which he claims to have suffered as a proximate result to the defendants' breach of contract of breach of implied obligation of good faith and fair dealing . . . [including] loss of future earning capacity as a result of the way in which he was dismissed.
>
> ". . . . .

> "If you find that the plaintiff's future earning capacity ha[s] been diminished, you must determine the present cash value of the earnings which plaintiff can reasonably be expected to have earned in the future if defendants' promises had been fulfilled, subtracting from that amount the present cash value of the earnings which plaintiff can now reasonably be expected to earn in the future."

Similarly, the common law fraud instruction stated:

> "Damages . . . include the following elements:
>
> If you find that plaintiff's career was damaged as a proximate result of the fraud, the amount of money which plaintiff would have been able to earn from the time of the fraud to the present time, deducting therefrom the amount which he reasonably could have earned, plus the present cash value of his earning capacity reasonably certain to be lost in the future as a result of the fraud."

Having failed to object to these instructions at the time of their submission, as is required by F.R.C.P. 51,[6] defendants have waived any errors therein. Questions as to the measure of damages may not be considered on appeal where they have not been raised at trial. *See The Prudence Company, Inc. v. Fidelity & Deposit Company of Maryland*, 297 U.S. 198, 207 (1935); *see also, Rouse v. Chicago, Rock Island and Pacific Railroad Co.*, 474 F.2d 1180, 1184 (8th Cir. 1973); *V-M Corp. v. Bernard Distributing Co.*, 447 F.2d 864, 867 (7th Cir. 1971); *Arkla Exploration Co. v. Brown*, 411 F.2d 879, 883-884 (8th Cir. 1969); 5 Am. Jur. 2d, *Appeal & Error*, § 640, pp. 94-95. Consequently, the alleged errors in the common law fraud and contract counts are not preserved for appellate review and we may not pass upon them.

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[6] F.R.C.P. 51 provides in relevant part:

> "No party may assign as error the giving or the failure to give an instruction unless he objects thereto before the jury retires to consider its verdict, stating distinctly the matter to which he objects and the grounds of his objection."

As to the correctness of the charge on the third theory of liability—securities law fraud—the parties hotly contest the question of preservation. The record clearly indicates that at one point during the instruction conference defendants objected to the proposed charge on the ground that career damages were not compensable in connection with a securities law violation.

But plaintiff argues that this basis for protest was subsequently waived when defendants expressly approved a redrafted version of the instruction,[7] objecting then specifically to only one matter not here relevant. Even if we assume, however, that the alleged error is preserved and has merit, defendants are not entitled to a reversal or a new trial because they cannot show that this error in any way affected the jury's decision. This is so due to the nature of the jury's verdict and the fact that the errors in the other two counts are not preserved.

The form of verdict returned by the jury, as noted earlier, awarded plaintiff one million dollars in compensatory damages against all defendants, but did not specify the theory under which liability was imposed. It further rendered separate verdicts against each defendant for punitive damages aggregating a second million dollars.[8] The district court thereafter entered a single judgment for compensatory damages imposing joint and

[7] The securities fraud instruction read in pertinent part:

"In order to determine that plaintiff is entitled to damages as a consequence of his claim of loss of business reputation as a result of the alleged securities laws violation, you must find that:

"1. But for the securities law violations, plaintiff would not have suffered this damage and that this damage cannot be attributed to any intervening cause which could not have been foreseen at the time of the securities law violation;

"2. [T]he damage to plaintiff's business career is not conjectural or speculative, but real and capable of being reasonably determined;

"3. [T]he plaintiff exercised reasonable care in an effort to minimize damage to his business career."

[8] The punitive damage verdicts were as follows: against Forni, $250,000; against Fisher, $150,000; against Zenith Distributing, $300,000; against Zenith Radio, $300,000.

several liability against all defendants and separate judgments for punitive damages against the individuals.

Presuming, as we must on appellate review, that the jury followed its instructions, it is clear that the compensatory damage award could not have been predicated solely upon the contract count for the breach of contract action was brought against only two defendants, Zenith Radio and Zenith Distributing, whereas the award was levied jointly against all four defendants.[9] Moreover, the contract count by itself could not have supported the punitive damage award, the jury having been properly charged that such damages could be imposed in this case only if defendants were found liable for common law fraud. The jury, nonetheless, without having found merit to the securities law charges, could have based its compensatory damage award exclusively on the common law fraud count, which was alleged against all defendants.[10] On this rationale, the jury would have been entitled to award damages for loss of future earning capacity, since it had been so instructed by the court, without objection by defendants. The imposition of punitive damages would also have been appropriate, assuming that the facts warranted such sanctions.[11] Because the jury's compensatory and punitive damage awards may have rested solely upon the common law fraud theory, which finds factual support in the record and as to which no error is preserved for review, we need not consider whether the section 10(b) and Rule 10b-5 count could have sustained an award of compen-

[9] The common law fraud and securities fraud counts were alleged against all four defendants.

[10] It might also be argued that the jury's verdict may have been based upon finding of liability under both the contract and common law fraud counts. However, this theory raises the unnecessary question of whether a compensatory damage verdict in one single sum against all defendants would have been appropriate where, for instance, both corporate defendants were found liable under two counts, but the individual defendants under only one. The jury instructions are not clear on this point and it need not be resolved since both the compensatory and punitive damage awards may be sustained solely upon the common law fraud theory.

[11] See the discussion of punitive damages, *infra*, at p. 25.

satory damages. Even if we assume *arguendo* that the instruction relating to the securities violation was erroneous it cannot be shown, other than on the basis of speculation or conjecture, to have affected the jury's decision, there being a totally adequate independent theory upon which the verdict may have rested. Defendants fall short of carrying the burden the law places upon them in attempting to disturb the judgment below. On appeal, "[e]rror is not to be presumed but must be made affirmatively to appear by the party asserting it . . . every intendment must be indulged in favor of the validity of the judgment appealed from." *Wabash Ry. Co. v. Bridal*, 94 F.2d 117, 121 (8th Cir.), *cert. denied*, 305 U.S. 602 (1938); *see also Berenter v. Staggers*, 362 F.2d 971, 972 n. 2 (D.C. Cir. 1966). It would be an abuse of our powers of appellate review to upset the judgment below on the basis of mere speculation.

Amount Of Compensatory Damages

While we conclude that defendants may not challenge the inclusion of career damages as an element in the computation of the jury's award, there remains the question of whether a value was assigned to this factor by the jury on the basis of speculation.[12] Defendants argue that it was improper for the jury to assume, in deciding

[12] On the matter of damage to plaintiff's career, the jury was charged:

"In the event that you find that plaintiff is entitled to damages arising in the future because of loss of earnings, you must determine the amount of these damages which will arise in the future.

"If these damages are of a continuing nature, you may consider how long they will continue. If they are permanent in nature, then in computing these damages you may consider how long the plaintiff is likely to live.

"With respect to a loss of future earnings, you may consider that some persons work all their lives and others do not; that a person's earnings may remain the same or may increase or decrease in the future.

"According to the evidence, the working life expectancy of a person aged 49 years is 15.3 years. This figure is not

(Footnote continued on following page)

to what extent McGrath's career was damaged, that McGrath would have had the most favorable experience possible as president of the acquired company and that his employment in that position or in a similar position with another company would have continued until McGrath chose to retire. We think there is merit in this contention.

Zenith could have fulfilled its promise to McGrath by making him president of the subsidiary. McGrath would have had no tenure and Zenith could have fired him at will as long as it acted in good faith. The question is whether plaintiff proved that it was likely that he would have continued as president, and for how long. At trial plaintiff's evidence on the issue of reduced earning capacity was presented primarily by Dr. Holmes and Dr. Linke. Dr. Holmes calculated plaintiff's pre-trial loss to be $347,431 by finding the difference between what an average executive occupying a position similar to the presidency of Basford would have made during those years and what McGrath actually earned. He further computed plaintiff's future losses to be $50,000 per year by projecting forward McGrath's pre-trial losses. Implicit in Dr. Holmes' calculations was the assumption that if McGrath had originally been made president of Basford he would have continued in that position or would have held an equivalent job elsewhere. There is, however, no evidence in the record to support this assumption. No one testified as to how long it was likely that McGrath would have retained the Basford presidency. Dr. Holmes did not address the question and, indeed, when asked whether he could "tell the jury how long after trial [McGrath's career damage] would extend on an annual basis," he said that he could not,

[12] *continued*
conclusive. It is the average work life expectancy of persons who have reached the age of 49. It may be considered by you in connection with other evidence relating to the probable life expectancy of the plaintiff in this case, including evidence of his occupation, health, habits, and other activities, bearing in mind that some persons live longer and some persons less than the average."

that he was "not qualified to do so." Similarly, Dr. Linke, who testified that the average work life expectancy for a person McGrath's age was 15.3 years, did not opine that it was likely that McGrath would have performed satisfactorily in the Basford position and would have continued to hold that office or a comparable job. Dr. Linke's calculations of the present cash value of plaintiff's pre-trial and post-trial losses (as determined by Dr. Holmes) simply assumed that plaintiff's employment would extend to the normal retirement age of 65. We must conclude that the jury was asked to speculate without evidence in the record that if McGrath had been given a decent interval as president, he would have continued to earn at that level for 15 or 16 years. Consequently, the million dollar compensatory damage award may not be upheld.

We think it appropriate to give plaintiff the option of accepting a reduced amount of compensatory damages or submitting to a new trial on the issue of compensatory damages only. While the verdict, with respect to future losses, was speculative because the jury had to assume continued life, employability, and favorable professional experience on the part of McGrath over a 15- or 16-year period, the same may not be said of the pre-trial losses component of the damage award. At the time those losses were assessed McGrath had already lived nearly six years past the breach of the contract, and to that extent the mortality factor was eliminated from the jury's deliberations. Also, the fact that plaintiff had worked for Fleetwood for three years in a high-level (though not equivalent) position provided some evidence of his continued employability as an executive. We think the evidence would have supported a verdict that McGrath, if he had been given the promised opportunity, would have worked at a higher level up until the time of trial. Bearing in mind that pre-trial losses extended over almost six years and that Dr. Holmes testified that, after adjustment for unusually low earnings in 1977 and 1978, McGrath's pre-trial losses averaged about $50,000 per year, we conclude that it is fair to offer plaintiff the option of accepting $300,000 in compensatory damages or being relegated to a new trial on that issue alone.

Punitive Damages

Defendants challenge the punitive damage awards on the theory that recovery of punitive damages depends upon proof that defendants actually intended to injure the plaintiff and that such evidence is wanting in the present case. We believe that defendants misstate the applicable standard and that when judged according to the correct rule the jury verdict is supported by the record.

Under California law, the "malice" necessary to support an award of punitive damages "does not necessarily mean personal spite or ill will toward the plaintiffs. A person may be found to act wantonly or maliciously or oppressively if he intentionally acts in a wilful violation and disregard of the rights of another, for the purpose of either causing loss or damage to such person, *or of bringing about profit or gain to himself.*" *El Ranco, Inc. v. First National Bank of Nevada*, 406 F.2d 1205, 1218 (9th Cir. 1968) (emphasis added'. In the present case, the jury could have concluded that the defendants were seeking to benefit themselves by the sale of Basford to Zenith, and that the transaction was possible only because McGrath's rights had been disregarded and he had been misled into relinquishing his option in reliance upon the statements and conduct of the defendants. In light of this and our earlier discussion of the evidence supporting a finding of common law fraud, we have little difficulty concluding that the jury was entitled to award punitive damages. While contrary inferences as to the intentions of the defendants might have been drawn from the evidence, that decision was one for the jury and is not subject to being disturbed on appellate review.

Finally, inasmuch as defendants do not specifically challenge the punitive damage awards as excessive or as totally disproportionate to the acts committed or to the wealth of the defendants, we note only that the amount of such awards is a matter for the discretion of the jury and that where, as here, there is the support of substantial evidence in the record, an appellate court should not substitute its judgment for that of the trier of fact.

Accordingly, we affirm the judgment appealed from, except insofar as concerns the award of compensatory damages, which cause is remanded to the district court in accordance with this opinion. Plaintiff is allowed two-thirds of his costs of appeal.

SWYGERT, *Circuit Judge*, dissenting. I respectfully dissent from the holding of the majority and would reverse the judgment of the district court.

I

I disagree with the majority's holding that the jury could permissibly have imposed liability against Zenith as the result of a breach of contract. In my judgment, neither an express nor an implied contract for the future employment of McGrath, with concomitant stock purchase opportunities and a possible bonus, was established by the evidence as a matter of law. McGrath testified that Fisher said that "it would have to be that there would be no contract." Fisher's additional statement to McGrath about the latter being the "heir apparent," expressed at most a future event entirely speculative—a conjectural not a guaranteed reality.[1]

[1] Immediately after being told that Zenith did not offer employment contracts to their executives, McGrath signed the following waiver, which makes no mention of any additional promises, implied or otherwise:

> ROBERT EDWARD MCGRATH ("McGrath") and ZENITH RADIO RESEARCH CORPORATION ("Zenith") agree as follows:
>
> 1. If Zenith acquires all of the outstanding Class B common stock of H. R. BASFORD & COMPANY pursuant to a certain agreement by and between the shareholders of H. R. Basford & Company, H. R. Basford & Company, and Zenith, then McGrath agrees to rescind that certain agreement dated August 18, 1971, between H. R. Basford & Company and Robert Edward McGrath, and Zenith agrees to cause H. R. Basford & Company to agree to such rescission.

II

I cannot agree with the majority's conclusion that the alleged misrepresentations to McGrath about his future employment relationship with Basford or its successor constituted fraud under section 10(b) of the Securities Exchange Act in connection with either the sale of his shares of Basford stock or the relinquishment of his conditional option to purchase additional shares. As for the sale, the alleged misrepresentations were made with respect to McGrath's future employment, not the sale of his securities. McGrath participated in negotiating the thirty-eight dollar price per share he and the other shareholders received for their stock. That price was agreed upon before the alleged misrepresentations were made, and it was stipulated at trial that the price was fair. No present employment opportunities or promises of future employment entered into the considerations given to fixing the price per share. Moreover, if such promises had caused a lower price, McGrath would have been given an unfair preference over the other Basford shareholders. McGrath's claim that he was misled would have resulted, if his claim of liability under Rule 10b-5 were allowed, in a serious wrongdoing at the expense of the other Basford shareholders. The sale as it stood netted him a $40,000 profit.

McGrath's claim that the relinquishment of his option to purchase additional shares of Basford stock constituted fraud in connection with the purchase of a security giving rise to liability under Rule 10b-5 is in my judgment contrary to the majority view, controlled by *Manor Drugs v. Blue Chip Stamps*, 421 U.S. 723 (1975). *See also International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979). Manor Drugs' decision to surrender its opportunity to buy Blue Chip shares was held to afford no basis for a Rule 10b-5 claim, even absent any preconditions to an exercise of that opportunity. Here, McGrath's opportunity to buy additional Basford shares was not unqualified but was subject to his continued employment for at least three years. The fulfillment of that condition was conjectural to say the least. *A fortiori* this case has less connection with the purchase of a security than *Manor Drugs*.

III

I am also unable to agree with the majority ruling that the alleged misrepresentation to McGrath about his becoming president of Basford or its successor constituted common law fraud in connection with McGrath's sale of Basford shares or the relinquishment of his conditional opportunity to buy additional shares.

The misrepresentations were made in connection with McGrath's future employment, not the sale of his Basford stock. He had participated in setting the thirty-eight dollar figure he and the other shareholders received, and it was stipulated at trial that the price was fair. Significantly, the price per share was negotiated long before the alleged misrepresentations were made.

Plaintiff argues that had he been told of Fisher's conversation with Forni, he might have blocked Zenith's acquisition of Basford by refusing to sell his Basford shares or to give up his conditional opportunity to buy more. McGrath, however, could not have effectively blocked the sale or kept his opportunity to buy. His right to keep his shares and the opportunity to buy more shares were contingent upon his continued employment by Basford. He could have been fired at any time. Under the terms of his contract, his right to buy more shares would have been extinguished, and he could have been forced to sell both his acquired shares to the employee stock trust at less than book value.

IV

Given my view of the case, I would not reach the question of damages. But if I did, I am of the opinion that the award of punitive damages in any amount was improper.

Punitive damages are not favored by the law and should be awarded only under extraordinary circumstances. Actual intent to injure a plaintiff is required. Here no such intent was demonstrated by the evidence. Rather, it shows that Fisher prevailed upon Forni to wait several months before making any decision about McGrath's future and that he was not in fact

fired until after Forni had observed McGrath's performance for four months under the new organization.[2] In addition, Fisher arranged benefits for McGrath more generous than those customarily given by Zenith or Basford. Forni furnished written reference to McGrath, and Fisher offered to serve as a reference. Finally, Zenith helped McGrath to find a comparable executive job with Fleetwood, a Canadian company. Surely these gestures of helpfulness by the defendants towards McGrath refute any malicious intent to harm him. To award him one million dollars in punitive damages in these circumstances is to work a grave injustice instead of rectifying one.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

[2] During that time, for example, McGrath escorted a group of Basford customers on a trip to Spain but let the customers return on their own, while he remained in Spain to extend his vacation.

APPENDIX B

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

May 20, 1981.

Before

Hon. Thomas E. Fairchild, *Chief Judge*
Hon. Luther M. Swygert, *Circuit Judge*
Hon. Walter J. Cummings, *Circuit Judge*

No. 79-1361

ROBERT EDWARD McGRATH,
Plaintiff-Appellee,

vs.

ZENITH RADIO CORPORATION, ZENITH DISTRIBUTING CORPORATION OF NORTHERN CALIFORNIA, WALTER C. FISHER and AMILE J. FORNI,
Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 75 C 2290

Stanley J. Roszkowski, Judge.

ORDER

This case is before the Court on a petition for rehearing and suggestion for rehearing *en banc* filed by defendants-appellants.

The original opinion issued by this Court on January 28, 1981, is modified by deleting from line 17 on page 2 the word "compensatory."

The opinion is further modified by inserting a new footnote at the end of the last sentence of the first full paragraph on page 14 stating:

"[5] Expressions found in *Frederiksen* v. *Poloway*, 637 F.2d 1147 (7th Cir. 1981), do not require a contrary result.

There stock in a corporation was transferred as an incident of the sale of a business. Frederiksen and his company, who were the buyers and plaintiffs, claimed they had been defrauded by the defendant seller and former sole owner. In *McGrath,* plaintiff was one of a number of people who had invested in Basford stock. Plaintiff as a seller of stock claimed fraud on the part of the buyer. The only fact in common with *Frederiksen* is that the buyer in the transaction became the sole owner of the corporation. The dispositive factor in *Frederiksen* was that '[t]he stock . . . merely was passed incidentally as an indicia of ownership of the business assets sold . . . ' Slip op. at 8. Neither in the hands of the sole shareholder/seller, nor in the hands of the purchaser who 'strongly assumed management control of the business,' slip op. at 12, did the purchase meet the requirements of the 'economic reality' test as representing an investment, by the person seeking protection of the securities laws, in a common venture premised on a reasonable expectation of profits to be derived from the efforts of others. In *McGrath,* in contrast, the Basford shares were investments on the part of the individual employees who held those shares. The Basford shares constituted 'securities' in the hands of plaintiff as well as the other sellers and they did not lose that status merely by reason of the fact that all of the Basford shares were sold at the same time. To conclude otherwise would be to hold that a purchaser of corporate shares may deprive investor-sellers of the protections of the securities laws if it can arrange that all of the corporation's shares are purchased at one time. Whatever the breadth of language, clearly *Frederiksen* does not require such a result."

The opinion is further modified by deleting from the last sentence on page 24 the words "that issue alone" and substituting the words "the issue of damages alone."

The opinion is further modified by deleting the second and third paragraphs on page 25 and substituting the following paragraphs and footnotes:

"Under California law, the 'malice' necessary to support an award of punitive damages is not necessarily

personal spite or ill will toward the plaintiff. There are decisions at the appellate level that hold that where there is a finding of fraud, that 'alone is an adequate basis for awarding punitive damages.' *Oakes* v. *McCarthy Company,* 267 Cal. App. 2d 231, 263, 73 Cal. Rptr. 127, 146 (1968); *see also Miller* v. *National American Life Ins. of California,* 54 Cal. App. 3d 331, 336, 126 Cal. Rptr. 731, 733 (1976) (construing the California punitive damage statute). In any event, the California Supreme Court has held in two recent cases that what is required is that the defendant have acted with 'an intent to vex, injure, or annoy, or with a conscious disregard of the plaintiff's rights.' *Neal* v. *Farmers Insurance Exchange,* 21 Cal. 3d 910, 922, 582 P. 2d 980, 148 Cal. Rptr. 387, 395 (1978); *Silberg* v. *California Life Ins. Co.,* 11 Cal. 3d 452, 462, 521 P. 2d 1103, 1110, 113 Cal. Rptr. 711, 718 (1977). One of these cases said that this state of mind can be proved either expressly or by implication. *See Neal, supra,* 148 Cal. Rptr. at 396, n. 6. In the present case, the jury could have concluded that the defendants were seeking to benefit themselves by the sale of Basford to Zenith, and that the transaction was possible only because McGrath's rights had been disregarded and he had been misled into relinquishing his option and stock in reliance upon the statements and conduct of the defendants. In light of this and our earlier discussion of the evidence supporting a finding of common law fraud, we have little difficulty concluding that the jury was entitled to award punitive damages. While contrary inferences as to the intentions of the defendants might have been drawn from the evidence, that decision was one for the jury and is not subject to being disturbed on appellate review.

"Finally, inasmuch as defendants do not specifically challenge the punitive damage awards as excessive or as totally disproportionate to the acts committed or to the wealth of the defendants, we note only that the amount of such awards is a matter for the discretion of the jury and that where, as here, there is the support of substantial evidence in the record, an appellate court should not substitute its judgment for that of the trier of fact. Accordingly, if plaintiff accepts $300,000 in compensatory dam-

ages, the award of punitive damages will remain undisturbed.[14] If, however, plaintiff submits to a new trial on damages, the new trial will embrace both compensatory and punitive damages.[15]

The opinion is further modified by deleting from line 2 on page 26 the word "compensatory."

On consideration of the petition for rehearing and suggestion for rehearing *en banc* filed by counsel for defendants-appellants, a vote of the active members of the Court was requested, and less than a majority of the active members of the Court have voted to grant rehearing *en banc.** A majority of the original panel voted to deny the petition for rehearing. Accordingly,

IT IS ORDERED, that in all respects other than the changes herein ordered the aforesaid petition for rehearing and suggestion for rehearing *en banc* be, and the same is hereby, DENIED.

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[14] Under California law, an appellate court may reduce the amount of an award of compensatory damages while leaving intact the punitive damage verdict. *See Walker* v. *Signal Companies, Inc.*, 84 Cal. App. 3d 982, 149 Cal. Rptr. 119 (1978). Here, the jury's four separate verdicts imposing punitive damages in differing amounts ($250,000 against Forni, $150,000 against Fisher, $300,000 against Zenith Distributing, and $300,000 against Zenith Radio) reflect a careful assessment of the gravity of each defendant's conduct and other relevant factors, and none of these awards may be said to be unreasonably disproportionate to the proper sum of compensatory damages, namely $300,000.

[15] This appears to be required by law of California, *see Liodas* v. *Sahadi*, 19 Cal. 3d 278, 284, 562 P. 2d 316, 137 Cal. Rptr. 635, 638 (1977) and the cases cited therein, and the parties have treated the law of California as controlling."

* Circuit Judge Wilbur F. Pell, Jr. did not participate in consideration of the petition for rehearing *en banc*. Circuit Judge Luther M. Swygert voted to GRANT rehearing and rehearing *en banc*.

APPENDIX C

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT
OF ILLINOIS

EASTERN DIVISION

Honorable
Stanley J. Roszkowski
Presiding Judge

No. 75 C 2290

March 6, 1979

ROBERT EDWARD McGRATH

vs.

ZENITH RADIO CORPORATION, ET AL.

ORDER

This court having carefully considered the defendants' Post-Trial Motion, including their alternative motion for remittitur, and the memorandum in support thereof, finds that the matters contained therein are insufficient to warrant any relief prayed for in said motion. The defendants' post-trial motions are, therefore, denied.

ROSZKOWSKI, J.

APPENDIX D

STATUTES AND RULE INVOLVED

United States Code, Title 15:

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Code of Federal Regulations, Title 17:

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

United States Code, Title 28:

§ 1331. Federal questions; amount in controversy; costs*

(a) The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the constitution, laws, or treaties of the United States, except that no such sum or value shall be required in any such action brought against the United States, any agency thereof, or any officer or employee thereof in his official capacity.

(b) Except when express provisions therefor is otherwise made in a statute of the United States, where the plaintiff is finally adjudged to be entitled to recover less than the sum or value of $10,000, computed without regard to any setoff or counterclaim to which the defendant may be adjudged to be entitled, and exclusive of interests and costs, the district court may deny costs to the plaintiff and, in addition, may impose costs on the plaintiff.

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* This section was amended December 1, 1980, after the submission of this case to the Seventh Circuit, to read as follows:

§ 1331. Federal Question

The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States.